CBO TESTIMONY

Statement of
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Federal Loan Guarantees for Rural Television Service

before the
Subcommittee on Telecommunications, Trade, and Consumer Protection
Committee on Commerce
U.S. House of Representatives

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CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
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Mr. Chairman and Members of the Subcommittee, I am pleased to be with you this morning to discuss providing federal loan guarantees to increase access to local television services. The proposed loan guarantee program is designed to encourage investment in systems that deliver local television signals to mostly rural markets that are unlikely to receive those signals through existing direct broadcast satellite (DBS) companies. In my statement today, I will provide an overview of some of the factors that affect the budgetary cost of such loan guarantees. I will also discuss options that might reduce the cost of the proposed program to the federal government.

Federal assistance for this venture would be likely to prove costly. Most of the proposals envision large capital investments. But the market for delivering local television signals would be both subject to competition and relatively small, making it difficult to ensure that large investments could be recovered, especially in the near term. Federal credit programs can shift—but not eliminate—the risk of such projects. The cost to the federal government would depend largely on the size of the program and how much of the risk was borne by the government.

FACTORS THAT AFFECT THE BUDGETARY COST OF LOAN GUARANTEES

Many options to provide federal loan guarantees for rural television service are under consideration. The Congressional Budget Office (CBO) has estimated the cost of one

proposal this session—H.R. 3615, as ordered reported by the House Agriculture Committee. My testimony this morning is based on our analysis of that proposal.

H.R. 3615 envisions a $1.25 billion loan guarantee program. Up to half of that amount could be awarded to a single borrower, with the remainder divided among several smaller borrowers (each receiving no more than $100 million). The loans would be used to finance the infrastructure needed to deliver local television broadcast signals—whether through satellite facilities, cable systems, or other wired or wireless systems. Although the legislation was written to cover a variety of possible technologies, key supporters argued that the program should be used to finance satellite transmission of local television signals.

The budgetary treatment of loan guarantee programs is governed by the Federal Credit Reform Act of 1990 (as amended). That act makes commitments of federal loan guarantees contingent on the appropriation of enough funds to cover the estimated subsidy associated with the guarantees. Under credit reform, the subsidy cost of a loan guarantee is the estimated long-term cost to the government, calculated on a net present-value basis. Budget authority for the subsidy is recorded in the year it is provided; outlays are shown in the year in which the guaranteed loans are disbursed.

The subsidy cost of federally guaranteed loans typically depends on the extent of any defaults and the degree to which those losses are offset by proceeds from liquidating collateral and by

income from fees or other charges. (Some loan guarantees also provide an explicit interest rate subsidy, which adds to the cost.) The credit risk of existing loan guarantee programs varies widely. Some programs have average default rates of less than 2 percent; others, between 10 percent and more than 20 percent, net of recoveries. Most existing programs guarantee a high volume of loans each year, effectively pooling the credit risk of many individual borrowers. In addition, fees—especially up-front fees—offset some of the subsidy cost of most loan guarantee programs.

In CBO's view, providing local television service in rural areas is likely to prove financially and technically risky. For such services to be economically viable, millions of households would have to be willing to pay a premium to satellite or other service providers to receive local television stations—even though most households can view those stations at no additional charge through their over-the-air antenna or existing cable subscription. Thus, borrowers of the proposed guaranteed loans might have trouble achieving the necessary level of market penetration for a new television service. In addition, unlike companies that provide rural electrification or telephone services, those borrowers would immediately confront competitors in the marketplace. They would also face numerous technical risks, including the risk that emerging technologies will allow local broadcast signals to be delivered to the home through less costly methods.

To estimate the subsidy cost of the loan guarantee program for rural television service, CBO consulted industry experts and investment analysts and examined the credit ratings of firms in the satellite television industry. That information is useful in estimating subsidy rates because the different credit ratings reflect analysts' expectations of defaults. For example, a January 2000 report by Standard & Poor's indicated that the cumulative default rate for investments with a "BBB" rating is less than 5 percent; for those with a single "B" rating, the default rate is 28 percent; and for those with a "CCC" rating, the rate is 44 percent. Based on our review of publicly available information about the ratings of companies in similar industries, we anticipate that the credit rating for rural television projects would be at the riskier end of that range.

We also examined the legislative terms and conditions that might mitigate such risk. For example, the loan guarantee program in H.R. 3615 would let the Administration decide how much collateral to require. Likewise, judgments about the reasonableness of borrowers' business plans and about the total amount of the loan guarantees would be made by the Administrator of the Rural Utilities Service. Finally, H.R. 3615 would authorize the Administrator to levy fees and accept a payment from a nonfederal source to fund all or part of the credit-risk premiums.

CBO estimated that the loan guarantee program authorized by H.R. 3615 would have a subsidy rate of about 28 percent of the total amount guaranteed. For a $1.25 billion loan guarantee

program, that translates into an estimated subsidy cost of about $350 million (assuming that the optional fees would not be charged or collected). Because H.R. 3615 would make implementation of the program contingent on future appropriation action, those costs would be discretionary. (A copy of our cost estimate for H.R. 3615 is attached.)

OPTIONS TO REDUCE THE COST OF LOAN GUARANTEE PROGRAMS

As I noted earlier, the cost of a loan program is determined largely by the riskiness of the venture and how much of that risk the government will bear. One way to reduce the cost of a loan guarantee program significantly is to reduce its size—either by decreasing the total obligation level or by guaranteeing less than the full value of each loan. Modifying the terms of the loan guarantees can also change the subsidy cost, but for the most part, such technical changes would have a relatively small effect on the cost of the proposed program. Other options to reduce subsidy costs include requiring borrowers to pay fees, protecting the government's security in the event of default, and ensuring effective underwriting criteria.

Reduce the Obligation Level

The simplest way to decrease the size of the program is to reduce the amount of loans that the government is offering to guarantee. H.R. 3615 would authorize guarantees totaling $1.25 billion. Lowering the amount of obligations would cause a proportional reduction in the government's exposure and thus in the subsidy cost.

Guarantee Less Than the Full Value of the Loan

Another way to reduce the potential cost to taxpayers is for the government to guarantee less than 100 percent of the value of each loan. About half of existing federal loan guarantee programs guarantee less than 100 percent of insured loans; some guarantee as little as 50 percent of the value of their loans. Examples at the lower end of the range are the Development Credit Authority program at the Agency for International Development (AID) and the Section 7(a) General Business Guaranty program at the Small Business Administration (SBA).

Guaranteeing less than the full value can reduce the cost to the government in two ways. First, it can lessen the government's direct exposure for each loan by lowering the dollar amount of the guarantee. Although that would reduce the cost of the proposed program, it would run the

risk that private lenders might be unwilling to lend enough funds to meet borrowers' needs. Second, it can reduce the default risk by encouraging private lenders to exercise more care in underwriting loans. The profit motive should push lenders to lend only to those borrowers most likely to repay the debt. Private lenders also have more expertise in analyzing business plans, industry trends, and financing options than their federal counterparts. However, having some degree of private financing is not a panacea for eliminating risk—both the AID and SBA programs mentioned above have default rates of about 15 percent.

Require Borrowers to Pay Fees

Most current loan guarantee programs require borrowers to pay either an up-front fee (when the loan is made) or an annual fee (collected as the borrower pays off the loan). Up-front fees are more common and typically range from less than 1 percent to more than 5 percent of the loan amount.

If properly designed, up-front fees can reduce the subsidy cost by a corresponding amount. Two caveats apply, however. First, there is a limit to the amount of fees that borrowers would be willing to pay—and that amount is likely to be far smaller than the subsidy cost of this program. Second, unless borrowers are prohibited from capitalizing the fee either directly (by adding it to the loan amount) or indirectly (by having third parties pay the fee, which would in

turn be recovered through higher costs for equipment or services), their debt-service costs, and thus the risk of default, will increase. Capitalizing fees can also result in borrowers' having insufficient collateral to support the loans.

Many federal programs, especially those involving housing and business loans, impose annual fees. The fees typically range from about 0.5 percent to 0.75 percent of the outstanding balance of a loan. Such fees can significantly reduce subsidy costs for programs that are characterized by a low risk of default and long maturities (between 15 years and 30 years). However, annual fees cannot be collected if a loan is in default, so they may not significantly reduce subsidy costs for programs in which the expected default rate is high.

Protect the Government's Security in the Event of Default

H.R. 3615 would allow the government's guarantee to be subordinate to any private-sector financing. Subordination would reduce the incentive for lenders to assess the riskiness of the loan and would increase the likelihood that if a default occurred, the government's loss would be significant.

Recoveries from subordinated debt have been lower than recoveries from senior debt in federal credit programs and in the private debt market. For example, the SBA guarantees financing to

businesses in the Section 504 Certified Development Company and the Section 7(a) General Business Guaranty programs. In the 504 program, the government's guarantee is subordinate to that of the lender; in the 7(a) program, the government's guarantee is equal in priority. Recoveries from defaulted loans have been significantly lower in the 504 program, even though it requires collateral in real estate and equipment and the 7(a) program does not. Making government liens superior to all other liens on the assets of the borrower could reduce the federal subsidy, relative to that of H.R. 3615.

Ensure Effective Underwriting Criteria

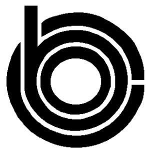
H.R. 3615 would direct the Secretary of Agriculture to develop underwriting criteria for the guaranteed loans in consultation with an independent accounting firm. Although CBO expects the resulting standards to be consistent with current government practice, lawmakers may want to spell out some of the criteria in law. For example, legislation could require that the liquidation value of the collateral be equal to the outstanding principal balance of the loan. Even at that level, however, collateral alone would not eliminate the subsidy cost of a program because of the time and expenses associated with care and preservation, liquidation, and litigation of the collateral.

The criteria for evaluating loans could also be strengthened. H.R. 3615 would allow projections of an applicant's ability to repay a loan to include the value of collateral pledged to protect the government's interest. Collateral provides a basis for recoveries in the event of defaults; it is not a substitute for cash flow. As a result, it is not a useful basis for determining whether an applicant's project is viable.

CONCLUSION

It is possible to reduce the cost of proposals to guarantee loans for delivering additional television services to rural areas, but it is not possible to eliminate all of the risk or cost of making such guarantees. In theory, the purpose of a federal loan guarantee is to provide credit for activities that the private marketplace considers too risky to pursue on its own. Such support comes at a cost.

The surest way to reduce the cost of proposals like the one included in H.R. 3615 would be to reduce the size of the federal loan guarantee. Other modifications, such as charging fees or improving underwriting criteria, are unlikely to reduce the estimated subsidy appreciably because the activities being financed are fundamentally risky. Options designed to reduce the cost to the government could make the program less attractive to potential borrowers or lenders, which in turn could reduce the demand for the loan guarantees.



CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

March 1, 2000

H.R. 3615

Rural Local Broadcast Signal Act

As ordered reported by the House Committee on Agriculture on February 16, 2000

SUMMARY

H.R. 3615 would establish a loan guarantee program for certain companies to provide local television service to areas of the country that do not receive local television stations from satellite companies. The bill would authorize the Administrator of the Rural Utilities Service (RUS) at the Department of Agriculture to guarantee loans to qualified borrowers, totaling up to $1.25 billion. The bill would authorize the appropriation of amounts necessary for the costs of the loan guarantees and associated administrative expenses.

Under the bill, one guaranteed loan could be as much as $625 million, but all other loans would have to be $100 million or less. Qualifying loans would be payable in full within the lesser of 25 years or the useful life of the assets purchased. H.R. 3615 would allow the government's guarantee to be subordinate to any private-sector financing and would give RUS broad authority to modify the terms and conditions of loans. The authority to guarantee loans would be contingent upon future appropriation action and would expire on December 31, 2006.

CBO estimates that implementing H.R. 3615 would cost about $365 million for loan subsidy and administrative costs over the 2000-2005 period, assuming appropriation of the necessary amounts. H.R. 3615 would not affect direct spending or receipts; therefore, pay-as-you-go procedures would not apply. H.R. 3615 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

For the purpose of this estimate, CBO assumes that H.R. 3615 and related supplemental appropriations will be enacted in fiscal year 2000. The estimated budgetary impact of

H.R. 3615 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By Fiscal Year, in Millions of Dollars					
	2000	2001	2002	2003	2004	2005
SPENDING SUBJECT TO APPROPRIATION						
Estimated Authorization Level	5	352	2	2	2	2
Estimated Outlays	2	233	124	2	2	2

BASIS OF ESTIMATE

Under procedures established by the Federal Credit Reform Act of 1990, the subsidy cost of a loan guarantee is the estimated long-term cost to the government, calculated on a net present value basis (excluding administrative costs). We estimate that the loan guarantees provided under the bill would cost about 28 percent of the total amount guaranteed—or $350 million, subject to the availability of appropriated funds. In addition, CBO estimates that administering the program would cost about $5 million in 2000 and about $2 million in each subsequent year. The bill would authorize the Secretary of Agriculture to charge fees, which could offset some of the subsidy or administrative costs, but this estimate assumes no fees would be charged.

To prepare this estimate, CBO consulted with industry experts and investment analysts and examined the credit ratings of firms in the satellite television and related industries. The information on credit ratings is useful because different credit ratings reflect analysts' expectations of defaults. Based on this information, we assume that the rural television loans likely to be guaranteed under this bill would have a credit risk comparable to debt rated as "B" or "CCC," which typically have default rates ranging from about 30 percent to 45 percent, respectively. We also estimate that provisions in H.R. 3615 allowing the government's guarantee to be subordinate to private-sector financing would increase the subsidy cost of such guarantees. Subordination would reduce the incentive for lenders to assess the riskiness of the loan and increase the likelihood that if a default occurred, the government's loss would be significant. Recoveries from subordinated debt have been lower than recoveries from senior debt in both federal credit programs and the private debt market.

PAY-AS-YOU-GO CONSIDERATIONS: None.

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 3615 contains no intergovernmental or private-sector mandates as defined in UMRA and would not affect the budgets of state, local, or tribal governments.

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